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In Practice
Embedded finance

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In this article Charles Kerrigan considers embedded finance and its implications for banking lawyers and lawyers generally.

In the September issue ((2020) 8 JIBFL 535) I wrote about revenue-based lending, a type of finance characterised by the integration of a lender into its customer's business. The two big themes in that article were personalisation and process. These are two of the themes that are central to much of the current thinking about innovation in finance. They underpin embedded finance.

Embedded finance gets attention for a couple of reasons. First, it is an area where technology companies* directly compete with traditional banks. So, for commentators it is interesting because it may be the thin end of the wedge, the point where non-banks overtake banks. Second, it is "embedded" in the sense it lives in the world of transactions, not just the world of banking transactions. So, for businesspeople it is interesting because its potential scale is vast. This scale prompts such startling headlines as 'Banking the Future: The $3.6 Trillion Embedded Finance Opportunity' from a recent Re: Bank podcast.

* I am here using the term technology companies in the way that I have done in writing over the last 10 or so years. I mean not just FANGMAN (the seven largest US tech stocks at the time of writing) but companies that are heavily reliant on technology and data, ie almost all companies.

We can look at this through a series of short questions. In doing so we can see that the topic illuminates some big themes in the banking sector.

What is embedded finance? The most common answer to that question is some version of embedded finance is the next stage in the evolution of fintech. That may be right but clearly it begs the question. The reason for this question begging is that the topic is somewhat amorphous and refers to products with some common features rather than a technical or legal innovation. Their main distinctive feature is that these products are built into any other interaction requiring a payment to be made at some point. There is not a separate search to access a financial product. This creates a symbiosis. The customer gets ease of use. The provider gets a greater level of insight into the customer. The product evolves to deliver a more personalised and seamless experience for the consumer. Examples of embedded finance products include buy now pay later (BNPL), embedded payments, embedded insurance and embedded lending. Providers include Klarna, Currencycloud, Salty and Shopify.

Have we seen this before? There are clear analogies in the history of payments and digital money. The most discussed objective in digital money for the last twenty years has been to reduce friction in payments transactions. This has been based on the logic that fewer clicks, less time inputting card numbers, fewer instances of completing very similar web forms improves the "customer experience". For the provider of the payments service or the merchant selling the product customer creates loyalty and cross-selling.

Why is this important now? There are two parts to the answer to this question. First, there are technical developments including the availability of big data and the computer processing power to manage it. Second, non-bank fintech companies and some banks are competing in innovation. Non-bank fintech companies are providing financial products. Klarna is an example. And banks are beginning to do distribution in new ways. Goldman Sachs announced a partnership with Walmart to offer access to capital to Marketplace sellers in September 2020. Both parts of the answer will have the same outcome. Payments, digital wallets and "banking-like" services will be integrated into e-commerce and internet companies in all sectors.

What does it mean for banks? A recent Corporate Performance Analytics report by the consultancy McKinsey predicts the long-term economic profit of banks is the worst of the twenty-three sectors considered. Simon Torrance in Fintech Futures sees this result as a proxy for the ineffectiveness of innovation at banks. Embedded finance is a difficult topic for banks because it is both the cause of and a solution to the problem of financial services revenues being crushed by over-competition and the over-supply of commodity services. Lex Sokolin, in his newsletter *The Fintech Blueprint*, gives the example of Robinhood, the US-based stock trading app. He notes that the company has transformed US stock brokerage "into mere information sold to market makers as order flow".

What now? There are two challenges. First: who can please customers more? If that is e-commerce businesses because they really know their customer (pun intended) the fact that it is financial products they are providing will be irrelevant. They will still displace banks from this business. That is the thesis of embedded finance. A bank that thinks that regulation will be a competitive advantage is unlikely to prosper. "Technology" companies are already providing financial services. The threat is to the ability of banks to keep meaningful customer relationships. These relationships exist in the "customer engagement layer" (the app, website, chatbot …) and embedded finance cuts banks out of this.

Second, what does the technology commercialised by native online businesses mean for financial services? The platform shift to cloud, software-as-a-service, artificial intelligence and blockchain means that human intuition can be generated mathematically from large data sets. This is directly applicable to fraud prevention, customer onboarding, anti-money laundering, trading, underwriting, and … client experience. Banks' operating performance will need to match that of native online businesses.

What does it mean for lawyers? The first point to note is that this question is not the same as what does it mean for finance lawyers. If the finance transaction is intrinsically part of a sale or other online transaction, this is where commercial, technology and regulatory lawyers work. Disintermediation of banks means disintermediation of bank lawyers. We will need to be product, industry and relationship lawyers able to advise banks renting or buying fintech B2B services. This is not hard, but it is different.

Challenger banks challenged banks with the question: can there be a better bank? Embedded finance challenges banks with the question: do customers need banks to access financial services? ■